What is a 401(k) Plan?

At is most basic level, a 401(k) plan is a profit sharing plan which gives participants the ability to defer income from their paychecks and contribute it to the plan. In fact, a 401(k) plan can have employee deferrals as the only type of contribution. In addition to traditional pre-tax deferrals a plan can allow Roth deferrals, matching contributions, profit sharing contributions, and safe harbor contributions (which can take the form of matching contributions or profit sharing like contributions.

Legislative History of 401(k) Plans

Section 401(k) was added to the Internal Revenue Code in 1978. In 1981, the IRS issued rules that permitted 401(k) contributions from payroll withholding.

Why was a law needed to make tax deferred contributions from payroll in a qualified plan?

Under basic principles of taxation, if an employee had a choice of receiving an amount of money currently or to defer the receipt of that money to a later date, the law treated the money as currently taxable. The participant could have chosen to receive the money and this resulted in “constructive receipt” even if the employee decided to defer it. Code Section 401(k) changed that result as long as certain rules were followed.

Small companies did not gravitate to 401(k) plans until the middle and later 1980’s. In part this was due to the need for investment companies to develop a record keeping infrastructure that were cost effective for small companies.

The original 401(k) plans required passing a non-discrimination test that divided employees into 2 groups based on compensation: the highest one-third and the lower two-thirds. The Tax Reform Act of 1986 revised testing to a version similar to what the regulations require today. Those provisions became effective in 1989.

The next major change occurred with the Small Business Job Protection Act of 1996. This law added the “prior year testing” option to 401(k) plans and changed the algorithm for returning excess contributions to highly compensated employees (when a test failed). The Act also created the vehicle known as the SIMPLE IRA. The biggest change, however, was the creation of “safe harbor” 401(k) plans. By adding either a profit sharing or matching contribution meeting certain requirements, a 401(k) plan could dispense with non-discrimination testing for deferrals and matching contributions. Safe harbor plans became effective in 1999. Today, some form of safe harbor is very common in small company 401(k) plans.

In 2001, the Economic Growth and Tax Relief and Reconciliation Act was enacted. This law made major changes to the 401(k) rules, most of which were effective in 2002. This law

increased: 401(k) limits, total amounts that an individual can have allocated to a defined contribution plan, deduction limitations, and the amount of compensation that can be counted under a qualified plan. The concept of catch up contributions also came from this law. The law also simplified the definitions of key employees in top heavy testing. With a delayed effective date of 2006, it added the ability to make Roth 401(k) contributions which do not have the income limitations of Roth IRA contributions. A variety of other changes relating to vesting and other matters were also addressed.

In 2006, Congress passed the Pension Protection Act. While most of this Act dealt with funding pension plans, there were significant provisions relating to 401(k) plans. These dealt mainly with the concept of automatic enrollment, also referred to as automatic contributions. Most 401(k) plans required participants to make an affirmative election to contribute. In the absence of an election, participants would have nothing contributed to the plan from their paycheck. Some plan sponsors had experimented with the idea of "negative elections" where a participant was enrolled by default and had to opt out of the plan. The idea took advantage of the fact that many participants are not likely to take any affirmative action, even to opt out of a particular deferral percentage. In other words, a savings by default.

The government viewed these arrangements favorably, as automatic contributions helped people to save for retirement. However, various issues arose that created a disincentive for employers to establish these plans. In some jurisdictions, there was a question whether automatic enrollment, even if a participant could opt out, would violate wage garnishment laws. There were additional concerns about participants who might opt out after just a few deposits leaving a very small balance in the plan. The Pension Protection Act addressed these concerns and others. It also created a variation on traditional safe harbors when packaged with a certain type of automatic contribution arrangement. In general these safe harbors provided plan sponsors with a small but significant economic advantage over traditional safe harbors. Finally, this law directed the Department of Labor to issue regulations on default investments in 401(k) plans, resulting in the abundance of target date funds seen today.

After the Pension Protection Act there have been a series of smaller changes to 401(k) plans. For example, the Uniformed Services Employment and Reemployment Rights Act dealt with the ability of active duty service people to access their accounts without penalties, as well as other related matters. IRS Rulings dealt with matters such as making mid-year changes to safe harbor plans, diverting distributions of after tax voluntary contributions to Roth IRA's, as well as other matters such as revamping rules on hardship distributions.

Eligibility:

A 401(k) plan can have an eligibility waiting period which cannot exceed one year of service from the date of employment. After satisfying the eligibility waiting period, participation can start as of an entry date which has to be at least twice a year.

Example 1:

Company X establishes 401(k) Plan Y. Plan Y requires an employee to satisfy one year of eligibility service before entering the Plan. Entry into the Plan is on the January 1st or July 1st following completion of one year of service. Jane starts working for Company X on April 14, 2019. On April 13, 2020 she completes one year of service. On July 1, 2020, she will enter the Plan.

A year of service can be defined to require an employee to receive credit for 1,000 hours of service, although the plan can require a lesser number of hours, or no specific numbers of hours at all. A detailed description of how hours are counted is beyond the scope of this general explanation.

A plan which provides for the employer to make other kinds of contributions, such as matching contributions or profit sharing contributions, can set a different eligibility requirement than the one for salary deferrals. In some cases, contributions other than salary deferrals can have a waiting period of up to two years. We refer to this as "bifurcated" eligibility. However, in plans which are top heavy, using bifurcated eligibility can force the employer to make substantial and unanticipated contributions. Professional advice is necessary when contemplating this design feature.

Example 2:

Company X maintains Plan Y. Plan Y requires no period of service to become eligible to make salary deferrals. A participant can start making salary deferrals on the first of the month following the date of their employment. Plan Y also matches salary deferrals $1 for $1 up to 4% of compensation. The employee enters the plan to receive matching contribution on the 1st day of the quarter, following the completion of one year of service.

Jane starts working for the company on August 15, 2019. She can start making salary deferrals on September 1, 2019. She completes one year of service on August 14, 2020. She starts to receive matching contributions as of October 1, 2020.

If a plan does provide for one year of eligibility service, once the employee achieves a year of service, that requirement has been met forever.

Example:

Jane worked 1,000 hours from her date of employment of 8/15/2019 to 8/14/2020. However, starting in September 2020 she started working only 15 hours per week. Jane satisfied her initial eligibility requirement, so she remains eligible to make her own contributions to the plan. More on this subject later when we discuss contributions.

If a participant does not meet the 1,000 in the first year of employment, then the plan is able to adopt language to shift future “eligibility computation periods” to a calendar year. This simplifies tracking eligibility for employees who do not earn 1,000 hours of service credit in their first year of employment.

The rules regarding qualified plans are quite complex. The explanations above are provided as general information and for educational purposes. They should not be relied upon as legal advice, advice on establishing a retirement plan, advice on interpreting a retirement plan, or for any purpose other than general information and education.

Vesting:

A 401(k) plan often provides for a vesting schedule for contributions that are made by the employer. Contributions made by the employee (such as pre-tax or Roth 401(k) contributions) are always fully vested. Safe harbor contributions made by the employer are, in general, fully vested. There are circumstances where safe harbor contributions can be subject to a 2 year “cliff” schedule. This means the participant is fully vested after 2 years of vesting service, but not at all vested before 2 years of vesting service.

For most 401(k) plans a year of vesting service means a calendar year in which the employee received credit for 1,000 hours of service. A lesser number can be required. The year of vesting service is credited at the point in the year employee has earned 1,000 hours of service. Although not common in small plans, a year of vesting service can require the employee to be employed throughout the entire year. However, if this option is selected, it is not possible to condition a year of vesting service on a having a certain number of hours credited.

Contributions:

Salary Deferrals or 401(k):

These are contributions withheld from an employee’s pay and submitted to the plan. The 2019 annual limit is $19,000 for participant who are younger than 50 at any time during the year. Participants who are age 50 or older at any point during the year can contribute an additional $6,000 of “catch-up” contributions for a total of $25,000 in 2019. For 2020, these limits

increase to $19,500 and $26,000 respectively. These limits may be annually increased, based on the government cost of living index and certain thresholds established under the tax code.

Salary deferrals can be traditional pre-tax deferrals or Roth deferrals. Pre-tax deferrals are not subject to federal taxes at the time of contribution. When they are taken out of the plan (and not rolled over to another tax deferred vehicle like a 401(k) plan or IRA), they are subject to federal tax.

Roth 401(k) deferrals are subject to federal tax when they are contributed. The actual Roth contributions, when withdrawn, are always federal tax free. The gains are also tax free if the money has been invested in the Roth vehicle for at least 5 years (starting with the first day of the year of the first contribution) and the person is at least age 59 ½.

The 401(k) deferral limit is based on the individual. Limits for employer paid contributions are based on the employer. Therefore, if an employee works at 2 companies and participates in 2 plans in the course of a year, then the $19,000/$25,000 limit is split between the 2 plans.

In addition to the dollar limits, there is a special non-discrimination test that applies to 401(k) deferrals of highly compensated employees. In general, a highly compensated employee is an employee who either owns more than 5% of the employer or who had compensation in excess of $125,000 in 2019 is highly compensated in 2020. (the limit increases to $130,000 in 2020 for the 2021 year determination). The determination can become complicated due to attribution between family members and ownership in related employers. A non-highly compensated employee is one who is not highly compensated.

The 401(k) test compares what highly compensated employees defer, as a percentage of compensation, relative to that for non-highly compensated employees. The testing can be complex as the rules provide for various options and methods. If the test fails, then corrective action must be taken. Most commonly this involves using an algorithm, defined under the regulations, to refund excess contributions to highly compensated employees. In some cases an employer can choose to correct the failure by making a special kind of fully vested contribution known as a QNEC (qualified non-elective contribution). Some plans impose a limit on what highly compensated employees can defer to reduce the likelihood of a 401(k) test failure.

Plans which have safe harbor contributions, discussed later, are exempt from the 401(k) test.

Automatic Enrollment in 401(k) Plans

This is a strategy which has gained popularity since the Pension Protection Act of 2006. Technically referred to as "automatic contributions" in the tax code and regulations, this method was originally referred to "negative elections" prior to the Pension Protection Act. The

Pension Protection Act cleared some potential legal hurdles relating to these kinds of arrangements and also created the Qualified Automatic Contribution Arrangement safe harbor discussed in the Safe Harbor section.

In a standard 401(k) plan a participant must affirmatively enroll to have contributions made from their paycheck. Automatic enrollment reverses that process. In plans with automatic enrollment, a participant is enrolled at a default rate upon becoming eligible to participant. The participant must be given the opportunity to opt out of the plan or to elect a different amount.

Some safe harbors can also be "Eligible Automatic Contribution Arrangements." This basically requires special language in the safe harbor notice allowing participants to request that money deposited into their account due to automatic enrollment be distributed to them. They must make the request for a distribution within 90 days of when the first automatic contribution was made.

All automatic contribution arrangements require notices with specific information in advance of the effective date, or for new participants a reasonable time before they become eligible. If the eligible waiting period is very short so that it is not practical to give an advance notice, the regulations allow for notice around the time the employee becomes eligible.

When considering an automatic enrollment arrangement, there are certain factors that should be taken into account:

- Which employees will be affected? For example: all participants or newly eligible participants after a certain date?
- What rate of automatic enrollment?
- How to handle participants who have already made elections?
- Will there be automatic increases? If so, when do they occur?
- How will this be administered? What are the respective roles of the record keeper, third party administrator, and the company maintaining the plan?

Basic Illustration of a 401(k) Test

Highly Compensated Employees:

Employee A has compensation of $150,000 and deferrals of $15,000. Deferral ratio- 10%

Employee B has compensation of $200,000 and deferrals of $19,000. Deferral ratio- 9.5%

Actual deferral percentage of highly compensated group- 9.75%

Non-highly Compensated Employees:

Employee C has compensation of $50,000 and deferrals of $1,500. Deferral ratio- 3%

Employee D has compensation of $60,000 and deferrals of $3,000. Deferral ratio- 5%

Actual deferral percentage of non-highly compensated group- 4%

Maximum allowable highly compensated deferral percentage: 4% + 2% = 6%

Step 1- Reduce each highly compensated deferral percentage to 6% and calculate total amount to be refunded.

6% of $350,000 ($200,000 + $150,000) = $21,000.

Amount deferred $34,000 ($19,000 + $15,000)

Deferrals to be returned to highly compensated: $34,000-$21,000=$13,000

Step 2- Apply amount to be refunded, first to person with highest deferrals and then in descending order.

Highly compensated employee B first has deferrals reduced by $4,000 from $19,000 to $15,000.

Then both Employees A and B have deferrals equally reduced until the total reduction is $13,000.

Each highly compensated employee has remaining deferrals of $10,500 after reductions.

B- $19,000-$15,000= $4,000. Remaining total amount to refund is $9,000.

A and B each have deferrals of $4,500 refunded to consume the $9,000 remaining to be refunded.

$15,000-$4,500=$10,500.

Matching contributions (non-safe harbor type)

A matching contribution is an employer paid contribution which directly relates to the amount of salary deferrals a participant makes. A matching contribution formula can be stated in the plan, be at the discretion of the employer, or some combination of the two.

Examples of matching contribution formulas and structures:

- Employer pays $1 for each $1 the employee defers with no cap.

- Employer pays $0.50 for each $1 the employee defers, with the match capped at 3% of compensation, i.e. employee defers 6% of compensation and receives a 3% of compensation match.
- Employer decides after each year end how much to match (this is uncommon)
- Employer sets a rate of matching contribution at the beginning of the year, but the rate remains at the employer's discretion to change.
- Employer has the discretion to set a rate of matching contribution, but does not match deferrals exceeding a certain percentage of compensation.
    - Employer matches deferrals up to 4% of compensation. The rate is determined at the discretion of the employer.

Profit sharing contributions

- These are contributions paid by the employer that do not relate to the amount of salary deferral contributions an employee makes. In other words, it is not a matching contribution. The simplest form of profit sharing contributions is a flat percentage of every eligible participant's compensation. For example, the employer makes a contribution of 4% of compensation to all eligible employees.
- Another more complex form of profit sharing essentially gives the employer the discretion to decide individually how much each participant receives as profit sharing. In these circumstances, the contributions must pass certain complex tests that are actuarial in nature. Each contribution a participant receives is converted to a theoretical pension payable are retirement using factors prescribed in IRS regulations. These theoretical pensions are then expressed as a percentage of compensation and certain tests prescribed in the regulations are performed. This technique is often referred to as "cross-testing" for the name given in the regulations, or as "new comparability" based on an update to an older IRS Revenue Ruling. Cross-testing is often used to provide greater benefits for owners of a company.
- Where cross-testing is not effective in meeting a company's objectives with profit sharing, an older technique is sometimes used, known as "permitted disparity." Like cross-testing, this derives from IRS regulations. It tends to provide slightly greater contributions, as a percentage of pay, for higher earning employees. This method has its roots in an older method called "social security integration." This technique took into account the fact that an employee earning over the social security taxable wage base does not receive additional social security benefits for this excess compensation. The profit sharing plan is essentially allowed to provide additional profit sharing for compensation over the taxable wage base.

- Example of Cross-Tested Profit Sharing with 401(k) for 2020:

				5.00%		
Participant	Age	Plan Compensation	401(k)	Profit Sharing	ER Total	% of Total
Owner 1	40	285,000.00	19,500.00	37,500.00	57,000.00	43.9%
Owner 2	45	285,000.00	19,500.00	37,500.00	57,000.00	43.9%
NHCE 1	34	22,000	440	1,100	1,100	0.85%
NHCE 2	35	100,000	3,000	5,000	5,000	3.9%
NHCE 3	48	45,000	1,350	2,250	2,250	1.7%
NHCE 4	51	30,000	900	1,500	1,500	1.2%
NHCE 5	65	25,000	1,000	1,250	1,250	0.96%
NHCE 6	29	50,000	2,500	2,500	2,500	1.9%
NHCE 7	27	45,000	2,250	2,250	2,250	1.7%
		887,000	50,440	90,850	129,850	100.00%

- Note that while the owners compensation represents 64% of the total compensation, the owners contributions represent almost 88% of total contributions (includes owners deferrals).

Top Heavy 401(k) Plans

A top heavy plan is a plan in which 60% or more of account balances belong to key employees. This is different than the 401(k) test previously discussed. The definition of key employee has some overlap with the definition of highly compensated employees, but it is a different definition under a different section of the tax code (Section 416). As with the 401(k) test, a top heavy test can be complex with a variety of adjustments.

If a plan is top heavy, then all non-key employees, must receive a top heavy minimum allocation that is paid by the employer. This contribution can be as large as 3% of the compensation of all eligible non-key employees.

Caution:

If the only contributions to a plan are employee salary deferrals and that plan becomes top heavy, the employer will need to contribute the top heavy minimum. In most cases, this is 3% of each eligible non-key employee's compensation, which can be a large number.

Plans which have only salary deferrals and safe harbor contributions, are treated as not being top heavy, regardless of the top heavy ratio.

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